NO. 8435

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

11

H. E. WARNER, Trustee of the PUGET SOUND QUALITY STORES, a Washington corporation, Bankrupt,

Appellant,

vs.

R. E. SCHONER, C. P. AINSWORTH, J. E. ROULLARD, and O. M. FREEBORG,

Appellees.

BRIEF OF APPELLANT

Upon Appeal from the District Court of the United States for the Western District of Washington Northern Division

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FILED

MAR 13 1937

PAUL P. O'BRIEN,
CLERK

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BRIEF OF APPELLANT

Upon Appeal from the District Court of the United States for the Western District of Washington Northern Division

JURISDICTION OF THE DISTRICT COURT AND OF THE CIRCUIT COURT OF APPEALS.

On the 20th day of September, 1934, three creditors of Puget Sound Quality Stores filed a petition in the District Court of the United States for the Western District of Washington, Northern Division, under cause No. 33499, praying that the said Puget

Sound Quality Stores, Incorporated, a Washington corporation, be adjudged a bankrupt within the purview of the Acts of Congress relating to bankruptcy. (Record 1) On the 24th day of September, 1934, another creditor of the said Puget Sound Quality Stores filed a petition in said proceedings as an intervening creditor wherein said creditor likewise prayed that the said Puget Sound Quality Stores, Incorporated, a Washington corporation, be adjudged a bankrupt within the purview of the Bankruptcy Act of 1898 and the amendments thereof (Record 4). On the said 24th day of September, 1934, an order was entered in said proceedings allowing said intervention (Record 10). On the 4th day of October, 1934, in said proceedings, an order was entered adjudging said Puget Sound Quality Stores Incorporated a bankrupt and referring further proceedings in the bankruptcy to the Honorable Ben L. Moore, one of the referees in bankruptcy of said court (Record 14). On the 30th day of October, 1934, an order was entered in said proceedings amending the records in respect to the name of the bankrupt and providing that the name of the Puget Sound Quality Stores be substituted in the place of Puget Sound Quality Stores Incorporated as the real, correct and legal name of the bankrupt and that all papers filed in said action be corrected and amended accordingly. (Record 16).

On October 29th, 1934, an order was entered appointing H. E. Warner as trustee of said bankrupt (Record 17) and on the 31st day of October, 1934, the said trustee qualified by filing his bond which was approved by the said Referee in Bankruptcy.

In the due course of the administration of the bankruptcy proceedings, the appellees filed general claims against the bankrupt estate, each in a sum in excess of $500. (Record 25, 29, 32, 35). The Trustee filed objections to the allowances of said claims (Record 23). Hearing was had upon the Trustee's objections to the allowance of said claims before the Referee in Bankruptcy resulting in the Referee's order entered on the 3rd day of December, 1936, overruling the Trustee's objections to said claims. (Record 52).

The Trustee, feeling aggrieved by the order of the Referee, filed on the 4th day of December, 1936, a petition for a review thereof as provided for in the Bankruptcy Acts of the United States with amendments thereto and under General Order XXVII. (Record 50). Upon such review the Judge of the District Court for the Western District of Washington, Northern Division, entered an order on the 14th day of December, 1936, confirming the Referee's order overruling the Trustee's objections to said claims and adjudging said claims to be allowable against the estate of the bankrupt as general claims and allow-

ing the Trustee an exception to said order. (Record 56).

The Trustee, conceiving himself aggrieved by the order of the District Court which confirmed the order of the Referee overruling the objections to said claims and allowing said claims as general claims against the estate of the bankrupt, filed a petition on the 22nd day of December, 1936, for an appeal from said order to the United States Circuit Court of Appeals for the 9th Circuit, and said appeal was allowed (Record 58). On said 22nd day of December, 1936, the Trustee filed Assignment of Errors (Record 59), Citation on Appeal (Record 61) and Praecipe for Transcript of Record (Record 62) and in due course the record of all of said proceedings was filed and this case docketed with the Clerk of the Circuit Court of Appeals for the 9th Circuit at San Francisco, California.

The District Court for the Western District of Washington, Northern Division, had jurisdiction to enter the order allowing the claims of the appellees as general claims against the estate of the bankrupt by virtue of 11 U. S. C. A., Sec. 11 (Bankruptcy Act of 1898, Sec. 2), which provides:

> "The courts of bankruptcy as hereinbefore defined, namely, the district courts of the United States in the several States, the Supreme Court

of the District of Columbia, the district courts of the several Territories and possessions to which this Act is, or may hereafter be, applicable, and the United States court in the district of Alaska, are hereby made courts of bankruptcy, and are hereby invested, within their respective territorial limits as now established, or as they may be hereafter changed, with such jurisdiction at law and in equity as will enable them to exercise original jurisdiction in bankruptcy proceedings, in vacation in chambers and during their respective terms, as they are now or may be hereafter held, to (1) adjudge persons bankrupt who have had their principal place of business, resided, or had their domicile within their respective territorial jurisdictions for the preceding six months, or the greater portion thereof, or who do not have their principal place of business, reside, or have their domicile within the United States, but have property within their jurisdictions, or who have been adjudged bankrupts by courts of competent jurisdiction without the United States and have property within their jurisdiction; (2) allow claims, disallow claims, reconsider allowed or disallowed claims, and allow or disallow them against bankrupt estates; * * * * (7) cause the estates of bankrupts to be collected, reduced to money and distributed, and determine controversies in relation thereto, except as herein otherwise provided; * * * * (15) make such orders, issue such process, and enter such judgments in addition to those specifically provided for as may be necessary for the enforcement of the provisions of this title; * * * * (17) pursuant to the recommendation of creditors, or when they neglect to recommend the appointment of trustees, appoint trustees, and upon complaints of creditors, remove trustees for cause upon hearings and after notices to them; * * * * ”

The United States Circuit Court of Appeals for the 9th Circuit has jurisdiction upon this appeal to review the order and judgment of the said District Court by virtue of 11 U. S. C. A., Sec. 48 (Bankruptcy Act of 1898, Sec. 25), which provides:

> "(a) Appeals, as in equity cases, may be taken in bankruptcy proceedings from the courts of bankruptcy to the circuit courts of appeal of the United States and the Court of Appeals of the District of Columbia, and to the supreme courts of the Territories, in the following cases, to-wit: * * * * (3) from a judgment allowing or rejecting a debt or claim of five hundred dollars or over. Such appeal shall be taken within thirty days after the judgment appealed from has been rendered, and may be heard and determined by the appellate court in term or vacation, as the case may be.
>
> (b) Trustees shall not be required to give bond when they take appeals or sue out writs of error."

STATEMENT OF THE CASE

This appeal comes before the court upon a stipulation of facts (Record 38), portions of which appellant believes to be surplusage and not necessary to a determination of the issues of law presented. Omitting those portions of the stipulation of facts which we deem unnecessary in order to succinctly present the question involved, we submit the following to be a concise statement of the case:

The bankrupt, Puget Sound Quality Stores, was incorporated on the 10th day of March, 1930, as a co-operative Association under the laws of the State of Washington for the purpose of dealing in groceries and merchandise upon a non-profit co-operative basis for the benefit of its member shareholders. The capital stock consisted of $500 divided into 500 shares of the par value of $1 per share.

Upon its incorporation, Puget Sound Quality Stores engaged in the business for which it was organized and continued the same until the appointment of a State court receiver in July 1934. On September 20th, 1934, an involuntary petition in bankruptcy was filed in the United States District Court of the Western District of Washington, Northern Division, and on the 4th day of October, 1934, Puget Sound Quality Stores was adjudicated a bankrupt. In the regular course of the business carried on prior to the appointment of the State court receiver, Puget Sound Quality Stores purchased merchandise in quantity from manufacturers and jobbers and in turn sold it out in lesser quantities to its member-shareholders who were engaged in the retail grocery business.

The by-laws, adopted at the first meeting of incorporators and Trustees on March 10, 1930, and ap-

proved by all of the member shareholders, provided in Article XV, as follows:

"Sec. 1. One per cent (1%) shall be added to all statements for the purpose of creating a credit reserve fund. Said one per cent (1%) shall be credited to each member's reserve fund account and shall be returnable with interest upon the member ceasing to be a member of the Association; less, however, a pro rata percentage of loss sustained by the Association on account of losses or credit extended to members of the Association."

"Sec. 2. The member's surplus account shall be a guaranty of his account with the Association, it being understood that said reserve fund shall be used to guarantee the accounts of all members with the Association who receive credit.

"Sec. 3. Statements shall be issued to members on the 1st and 15th of each month for goods purchased through or from the Association. The statement of the first of the month shall be delinquent on the 12th of the month, and the statement of the 15th of the month shall become delinquent on the 25th. Credit shall be refused to any member who shall have two such statements unpaid and such credit shall not be renewed until the delinquent accounts of the mem-

ber are paid. All delinquent accounts will draw penalties of one per cent (1%) per week."

Prior to May 30th, 1931, but not thereafter and pursuant to the by-law provisions above quoted, the Puget Sound Quality Stores added for the credit reserve fund, one per cent (1%) to the amount of each statement for each bill of merchandise sold by it to its member shareholders. The amount of said one per cent (1%) so contributed by each member shareholder was credited to his individual credit reserve account in the books of the company.

Each of the appellees (and other persons similarly situated) is a member of Puget Sound Quality Stores, holding one share of stock, and has paid into the credit reserve fund, under the provisions of the by-laws quoted, in the course of business as aforesaid, prior to May 30, 1931, and has been credited therefor in his individual reserve fund account, the following respective amounts:

R. E. SCHONER	$536.94
C. P. AINSWORTH	660.91
J. E. ROULLARD	587.61
O. M. FREEBORG	558.32

for which amounts each of said appellees has filed a general claim against the estate of the bankrupt, and to which claims the appellant filed objections.

The credit reserve fund of the bankrupt was deposited in the same bank account with other funds. The bankrupt operated at a loss in the years 1930 and 1931 and its funds in the bank were drawn from time to time to pay such losses.

The minutes of the meeting of the Board of Trustees of the bankrupt held May 11, 1931, show the following, to-wit:

> "The following resolution was duly offered, seconded and unanimously adopted:
>
> *Be It Resolved*, that the by-laws of this association be amended by striking therefrom sections 1 and 2 of Article XV, and that said amendments be made to take effect June 1, 1931.
>
> A motion was made, seconded and unanimously adopted that one per cent (1%) be added to the cost of merchandise in fixing the selling price of the same, and that the proceeds thereof be placed in the general funds of the Association."

The claimants neither knew of nor consented to the action of the Board of Trustees at their said meeting of May 11, 1931, and neither knew of nor consented to any attempted change in the text or construction of the original by-laws governing credit reserves or any change or amendment of the original by-laws by any means respecting such reserves.

The assets of the bankrupt which the trustee has completely reduced to cash, are insufficient to pay in

full the general claims of creditors whose claims have been filed and allowed, other than and exclusive of the claims of the credit reserve claimants whose claims have been filed in the bankruptcy proceedings.

SPECIFICATION OF ASSIGNED ERRORS

The assigned errors upon which the appellant relies (Record 59) are as follows:

1. That the District Court of the United States for the Western District of Washington, Northern Division, in entering the order approving and confirming the order of the referee and allowing the claims of the claimants therein named (the appellees), held that the credit reserve fund created by the bankrupt was subject only to losses extended to members of the bankrupt, whereas, under the by-laws of the bankrupt the credit reserve fund was applicable to all losses of the bankrupt corporation.

2. That the said District Court, in making said order, held that the claimants (appellees), as contributors to the credit reserve fund, are on a parity with all general unsecured creditors, whereas credit reserve contributors are entitled to dividends only after payment in full of the claims of general creditors of the bankrupt.

ARGUMENT OF THE CASE

I

The District Court of the United States for the Western District of Washington, Northern Division, in Entering the Order Approving and Confirming the Order of the Referee and Allowing the Claims of the Claimants Therein Named (the Appellees) Held that the Credit Reserve Fund Created by the Bankrupt was Subject Only to Losses Extended to Members of the Bankrupt, Whereas, Under the By-Laws of the Bankrupt the Credit Reserve Fund was Applicable to All Losses of the Bankrupt Corporation.

A determination of the controversy here on appeal is dependent not upon any particular rule of law or statute, but is dependent upon a proper interpretation of Article XV of the by-laws of the bankrupt (Record 39, 40), the first two sections of which provide as follows:

> "Sec. 1. One per cent (1%) shall be added to all statements for the purpose of creating a credit reserve fund. Said one per cent (1%) shall be credited to each member's reserve fund account and shall be returnable with interest upon the member ceasing to be a member of the Association; *less, however, a pro rata percentage of loss sustained by the Association on account of losses or credit extended to members of the Association.*" (Italics ours.)

> "Sec. 2. The member's surplus account shall be a guaranty of his account with the Association, it being understood that said reserve fund shall be used to guarantee the accounts of all members with the Association who receive credit."

It is the contention of the appellant that a proper interpretation of this by-law, and particularly that part which has been italicized, necessarily calls for a conclusion that the credit reserve fund must be charged with all losses incurred by the bankrupt in the operation of its business before any portion thereof is available for return to the members of the bankrupt who created the fund. If appellant's contention be correct, then it follows that the claims of appellees which arose out of deposits made by them to the credit reserve fund, must be disallowed because the obligations incurred by the bankrupt in the operation of its business (exclusive of credit reserve fund claimants) far exceed the assets of the bankrupt, all of which have been reduced completely to cash by appellant (Record 46).

The order of the Referee, confirmed by the District Court, held that the credit reserve fund was created for the mere purpose of protecting the bankrupt against loss due to credit extended by it to its member shareholders. A proper foundation for this order would have been laid had that portion of Article XV, Section 1 of the by-laws of the bankrupt above italicized read as follows:

> "less, however, a pro rata percentage of loss sustained by the Association on account of credit extended to members of the Association."

But this portion of the by-law included the words "losses or" just preceding the words "credit extended" and reads as follows:

> "less, however, a pro rata percentage of loss sustained by the Association on account of losses or credit extended to members of the Association."

By-laws are self-imposed rules, resulting from an agreement or contract between the corporation and its members to conduct the corporate business in a particular way.

> 7 R C. L. 143, §114;
>
> *Model Land & Irrigation vs. Madsen,* 87 Colo. 166, 285, Pac. 1100;
>
> *McConnell vs. Owyhee Ditch Co.,* 132 Ore. 128, 283 Pac. 755.

In the interpretation of a contract, it is the duty of a judiciary to ascertain the meaning and intent of the parties as expressed in the language used.

> 6 R. C. L. 835, §225;
>
> *Hawkeye Commercial Men's Association vs. Christy,* 294 Fed. 208, 40 A. L. R. 46;
>
> *Wood vs. Employers Liability Assurance Corp.* (C.C.A. 7th), 41 Fed. (2) 573, 73 A. L. R. 79.

When the by-laws of the bankrupt were framed and adopted with the approval of appellees, the parties must have intended to bind themselves in accord-

ance with the language therein used. Appellant readily acknowledges that the wording of Article XV, Sec. 1 of the by-laws is awkward, but this fact is not justification for arbitrarily deleting certain words therefrom. A proper interpretation of this section of the by-laws requires a careful consideration of every word used therein with a view to determining the intention of the adopters as expressed by the whole provision. The only reasonable conclusion to be reached is that before any member of the bankrupt would be entitled to a return of his reserve fund, he would have to first be charged with his pro rata percentage of loss sustained by the bankrupt in the general operation of the business and also to loss sustained on account of credit extended to its members.

Article XV, Sec. 2 of the by-laws of the bankrupt, completely covers the extent to which the credit reserve fund shall stand as security for the accounts of members of the bankrupt. This section provides:

> "Sec. 2. The member's surplus account shall be a guaranty of his account with the Association, it being understood that said reserve fund shall be used to guarantee the accounts of all members with the Association who receive credit." (Record 39.)

In other words, Sec. 2 makes each member's reserve fund account a guaranty of his account for

credit extended to him by the bankrupt and in addition thereto makes the credit reserve fund a guaranty for all of the accounts of all members to whom credit has been extended by the bankrupt. If the contention of the appellees that the credit reserve fund cannot be applied to any losses other than those sustained through extension of credit to members is sound, such understanding is covered entirely by Article XV, Sec. 2 of the by-laws, and the last clause of Sec. 1 would be mere surplusage.

What then was intended to be covered by the provision that the reserve fund shall be returnable "less, however, a pro rata percentage of loss sustained by the Association on account of losses or credit extended to members of the Association"? The only reasonable interpretation of the language of this clause, considered together with the other provisions of Article XV of the by-laws, is that losses both from the general operation of the business of the bankrupt and from credit extended to its members should be charged against the credit reserve fund.

That which was done by officers or directors of the bankrupt subsequent to the passage of the by-law in question, in contravention of the rights of appellees, and whether or not merchandise and other creditors of the bankrupt extended credit in reliance upon the

existence of the credit reserve fund, is immaterial to the issue presented by this appeal. The by-law adopted by the bankrupt corporation and approved by the member shareholders (including appellees) became a binding contract between them, under which a credit reserve fund was created to stand as a guaranty to cover all losses of the bankrupt.

II.

The District Court of the United States for the Western District of Washington, Northern Division, in Making the Order Approving and Confirming the Order of the Referee and Allowing the Claims of the Claimants Therein Named (the Appellees), Held that the Claimants (Appellees) as Contributors to the Credit Reserve Fund, Are On a Parity with All General Unsecured Creditors, Whereas Credit Reserve Contributors Are Entitled to Dividends Only After Payment in Full of the Claims of General Creditors of the Bankrupt.

The capital stock of the bankrupt consisted of only 500 shares of the par value of $1 per share. Each of the appellees, and other persons similarly situated, became shareholders of the corporation to the extent of one share of stock for the express purpose for which the bankrupt corporation was formed, that is, to obtain the advantages of a central buying organization for independent retailer grocers. The reserve fund was for the purpose of providing the bankrupt with a working capital and its creation was in the na-

ture of a capital contribution. It should be so considered in view of the provisions of Article XV of the by-laws, both for the proper protection of the general creditors of the bankrupt and with a view to an equitable distribution of the assets of the bankrupt in accordance with the purpose of the bankruptcy law.

Appellant having established his contention that the credit reserve fund was created to stand as a security for losses of the bankrupt incurred in the general operation of the business, as well as for losses resulting from credit extended to its members, and that said credit reserve fund is in reality a capital contribution to the bankrupt corporation, it follows as a matter of course that appellees cannot recover monies which they paid into the credit reserve fund until the claims of all other creditors have been paid in full. Appellees' claims are for recovery of their respective shares of a fund to which they subscribed for the protection of other creditors and their claims must necessarily be subordinated to the claims of the creditors intended to be protected thereby.

CONCLUSION

This appeal presents no factual controversy nor any intricate problems of law. Rather, it involves a reasonable interpretation of the awkward wording of

a corporate by-law which became a contract between the corporation and its shareholders. In the consideration of such a problem honest opinions differ. We submit that the Referee in Bankruptcy and the Judge of the District Court erred; that a proper interpretation of article XV of the by-laws of the bankrupt necessitates a conclusion that the claims of the appellees must be subordinated to the claims of the general creditors of the bankrupt.

Respectfully submitted,

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